

1 KIAWAH ISLAND UTILITY, INC.

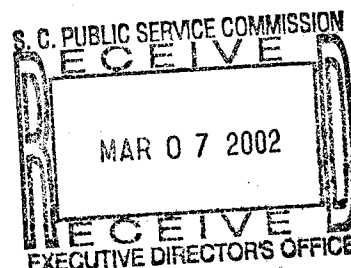
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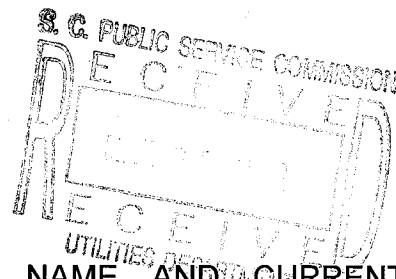
3 PRE-FILED DIRECT TESTIMONY OF RUSSELL A. HISSOM, CPA
4 BEFORE THE SOUTH CAROLINA PUBLIC SERVICE COMMISSION

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6 Testimony Prepared: March 5, 2002

7 Hearing Date: March 13, 2002



9 THIS TESTIMONY IS FILED PURSUANT TO PSC ORDERS DATED JANUARY 15,
10 2002. THE INTERVENOR RESERVES THE RIGHT TO SUPPLEMENT THIS
11 TESTIMONY AND PROVIDE FURTHER RESPONSIVE TESTIMONY IN RESPONSE TO
12 THE TESTIMONY THAT WILL BE PREFILED BY THE APPLICANT AND COMMISSION
13 STAFF.



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15
16 MICHAEL A. MOLONY: PLEASE STATE YOUR NAME AND CURRENT
17 OCCUPATION.

18
19 RUSSELL A. HISSOM: My name is Russell A. Hissom and I am a partner with Virchow,
20 Krause & Company, LLP a Certified Public Accounting and Consulting Firm. Our firm
21 consists of over 800 associates in 15 offices and rank as the 14th largest accounting firm
22 in America. My division is the Public Sector Practice Group, which consists of over 120

1 staff members, who provide audit and also water, wastewater, electric and
2 telecommunications consulting services to over 275 utilities.

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4
5 MR. MOLONY: HAVE YOU SERVED AS AN EXPERT WITNESS BEFORE?

6
7 MR. HISSOM: I have provided testimony before regulatory bodies and utility oversight
8 boards in Wisconsin, Illinois, Minnesota, Michigan, Nebraska, North Carolina, New
9 Mexico and Iowa. As a partner in a certified public accounting firm and personally as a
10 CPA, I am required to maintain independence in performing all services.

11
12 I am also a member of the American Waterworks Association, American Public Power
13 Association, and various state utility industry associations.

14
15 MR. MOLONY: WHAT IS YOUR INVOLVEMENT IN THIS CASE?

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17 MR. HISSOM: I was retained by the Town of Kiawah Island to review the rate filing of
18 the Kiawah Island Utility - Docket # 2001-164-W/S for reasonableness in its request for
19 water and sewer increases for the Town.

20
21 MR. MOLONY: WHAT HAS COME TO YOUR ATTENTION AS PART OF YOUR
22 REVIEW?

1 MR. HISSOM: There are several areas that have come to my attention during my
2 review of the filed application and other information from past applications and
3 testimony that I feel should be discussed and addressed in these proceedings. They
4 cover both operational and financial issues.

5
6 MR. MOLONY: WHAT HAS COME TO YOUR ATTENTION AS PART OF YOUR
7 REVIEW OF OPERATIONAL ISSUES?

8
9 MR. HISSOM: Operationally, the relationship between the Kiawah Resort Associates
10 and Kiawah Island Utility appears to result in related party transactions. For example,
11 Directors of KRA also serve as Officers of KIU. Also, in some transactions that have
12 occurred between KRA and KIU in the past, plant assets of KRA have been "sold" to
13 KIU at costs that reflect historical installed cost or current replacement cost, or perhaps
14 costs whose basis cannot be identified. This would not appear to be a customary
15 "parent-subsidary" relationship and is not common utility practice in my experience. It
16 is also not a typical "developer-utility" relationship.

17
18 In a typical "developer-utility" relationship, developers bear the cost of water and
19 sewer plant infrastructure and include those costs in the cost received for the property
20 being sold. That plant infrastructure is then contributed at no cost to the utility providing
21 service in that service territory. The utility is responsible for future maintenance and
22 eventual replacement of that plant. These costs are recovered from ratepayers through

1 rates for recovery of operation and maintenance and depreciation expenses and return
2 on rate base or, as in the case of some utilities, such as KIU, an operating margin.

3
4 In documents that I reviewed, utility plant shown as "Unidentified Assets" were
5 sold by KRA to KIU in 1991. Per the documents, these assets consisted of \$892,000 of
6 transmission plant that was supposedly not on the books of KIU. As KIU obtained
7 financing for this transaction to pay KRA, KIU lost the ability to use these funds for
8 future utility plant needs or operation expenses and Kiawah Island ratepayers have
9 seen this interest expense included in their rates. Schedules that I reviewed show that
10 imputed interest on this debt obligation totals \$1,020,000 over the period of 1991 –
11 2001, bringing the total to \$1.9 million. Other transactions I reviewed included hydrants
12 sold by KRA to KIU (\$300,000, including imputed interest) in 1991 and water and sewer
13 lines and equipment sold by KRA to KIU in 1996 (\$1,100,000 including imputed
14 interest).

15
16 Another related party transaction that came to my attention was in regards to KIU
17 leasing land from KRA. KIU has built utility infrastructure on the leased sites – holding
18 ponds and storage tanks. Typically, utilities own the land on which they build
19 immovable infrastructure, as the intent of the utility is to use the land for at least the
20 useful life of the plant on that property until the plant is taken out of service and retired.
21 In addition, in Items 6 and 7 of the KRA/KIU Service Agreement, KIU has the ability to
22 purchase these properties from KRA for one-half of the current market value at any time
23 during the lease period.

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Typically, in planning for future growth and the need to add future infrastructure, utilities impose impact fees on parcels of undeveloped property within their service territory. When the property is sold, the monies collected from impact fees are held in reserve by the utility until sufficient properties are developed to create a need for further utility plant expansion. This is a common industry practice and its foundation is based on the industry premise that current ratepayers should not pay for future growth, i.e. current ratepayers should pay for the maintenance, replacement and rate of return on the plant that was put in place to serve them. I did not find this to be the case for KIU and its service territories. However, survey results that I reviewed detailed that at 22 water and wastewater utilities in South Carolina, developers pay for water and sewer plant added in areas being developed. Of those 22 utilities, 15 of them collected utility impact fees for future expansion of their water and wastewater systems.

MR. MOLONY: WHAT HAS COME TO YOUR ATTENTION AS PART OF YOUR REVIEW OF FINANCIAL ISSUES?

MR. HISSOM: The applicant is requesting that an annual management fee of \$100,000 payable to KRA be included in the revenue requirement. Ms. Dennis pre-filed testimony describes the services performed by KRA employees for KIU to warrant the \$100,000 management fee. Some of the services described appear those that would be performed by a developer as part of its development services in the effort to sell property. Other services provided (preparation of payroll, human resources support)

1 appear to be services that should be reimbursed by KIU, however, there does not
2 appear to be a methodology in place to determine the costs that should be allocated
3 from KRA to KIU. Such a method could include keeping timesheets, or developing a
4 cost allocation method that is acceptable to the Commission and verifiable by outside
5 auditors.

6
7 In my review of the purchased water expense, it was not possible to determine if
8 additional water purchases have been included in the test year to fill the Aquifer Storage
9 Recovery System. If so, these additional costs have been included in the test year, they
10 should be normalized for rate purposes.

11
12 The operating margin requested by the applicant (10.75%) is in excess of the
13 operating margin approved by the Commission for KIU in its 1996 rate application
14 (3.55%).

15
16 The operating margin approved in recent Commission orders does not seem to
17 have had a negative impact on customer service, as KIU reports few customer
18 complaints. KIU's cash position appears adequate, based on my experience, with over
19 two months of unrestricted cash available to pay operating expenses.

20
21 Testimony reviewed in prior rate proceedings of KIU reveal that tap-in fees and
22 Building Incentive Fees were not included in the calculation of the rate base as
23 Contributions in Aid of Construction. The amounts detailed were \$241,000 of Sewer

1 tap-in-fees for 1992 – 1994 and \$530,000 of Building Incentive Fees for 1992 – 1995.
2 As these amounts were payments for utility plant additions, including depreciation
3 expense for these plant additions in the revenue requirement has the effect of KIU
4 collecting depreciation through rates for plant that it did not finance with internal funds.

5
6 Interest expense has been impacted by the financing needed by KIU to purchase
7 the \$892,000 in "Unidentified Assets" in 1991 from its parent company KRA, and in
8 subsequent purchases of plant by KIU from KRA . In many developer-utility
9 relationships this plant would have been donated by the developer to the utility. Cash
10 utilized in repaying this debt annually could be used to finance operations and capital
11 additions.

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13 MR. MOLONY: DO YOU HAVE ANY RECOMMENDATIONS FOR THE
14 COMMISSION?

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16 MR. HISSOM: Based on my review and observations, my recommendations in this rate
17 application are as follows:

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19 A rate increase should not be granted until the following issues have been
20 addressed:

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1 1. Impact fees should be established by KIU on all undeveloped property on the
2 island. The fees should be calculated to recover future capacity expansion
3 needed for water and sewer mains and hydrants.

4
5 2. Interest expense resulting from related party plant purchases by KIU from
6 KRA should be eliminated from the revenue requirement.

7
8 3. An independent 3rd party should determine if it is financially beneficial to KIU
9 to purchase property current leased from KRA.

10
11 4. The management fee should be excluded from the revenue requirement until
12 an accounting methodology is be developed to accurately track actual KRA
13 staff hours spent serving KIU and the resulting actual charges based on
14 stated employee hourly rates.

15
16 5. Depreciation on utility plant that was financed with tap-in fees and Building
17 Incentive Fees should be calculated and removed from the revenue
18 requirement.

19
20 MR. MOLONY: DOES THIS CONCLUDE YOUR TESTIMONY?

21
22 MR. HISSOM: Yes, at this time.